COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Investigation by the Department of Telecommunications and Energy on its own motion as to the propriety of rates and charges as set forth in tariffs M.D.T.E. Nos. 1 and 2, filed with the Department on April 13, 2001 to become effective May 1, 2001 by Pinehills Water Company, Inc.	)	D.T.E. 01-42

BRIEF OF PINEHILLS WATER COMPANY, INC.

I. INTRODUCTION

A. Procedural History

On April 13, 2001, the Company filed with the Department of Telecommunications and Energy (the "Department") an initial set of rates, M.D.T.E. Nos. 1 and 2, setting forth rules and regulations and proposed charges for water service. On April 18, 2001, the Department suspended the effective date of the proposed rates until November 1, 2001, pending an investigation into the propriety of the proposed tariffs.

On June 14, 2001, pursuant to notice duly published, the Department held a public hearing in the Town of Plymouth. No customers or other members of the public commented. On June 19, 2001, the Department held a procedural conference.

Because suspension of the Company's rates precluded the Company from charging for water service to the customers that had initiated service, the Company proposed that it be permitted to charge interim rates. Such rates would equal one-half of the volumetric charges (i.e. $4 per thousand gallons) and 75% of the connection and other ancillary charges that were proposed in the initial filing, pending completion of the Department's investigation. By Order dated August 13, 2001, the Department permitted the Company to implement interim rates equal to one-half of the volumetric charges and 75% of the connection charges that were proposed in the initial filing, all subject to refund should the Department's investigation show that such rates were not justified. During July and August, the Department issued and the Company responded to numerous information requests. On August 29, 2001, the Department held an evidentiary hearing at its offices in Boston. The Company presented two witnesses: Deborah Sedares, Counsel and Regulatory Permit Manager for The Pinehills; and Stephen B. Alcott of Alcott Associates, the Company's expert regarding cost of service and rate design. This brief is filed in accordance with the established procedural schedule.

B. Description of the Company

The Company is a new water company established to serve The Pinehills Community, ultimately a mixed residential and commercial use development in Plymouth, Massachusetts over an area of about 3,000 acres. When fully built out[1], The Pinehills will have over 2,800 residential homes and 1,300,000 square feet of general commercial and retail buildings (including offices, hotels, conference centers, restaurants and retail stores). Pinehills Water Company will provide the water service to all such homeowners and businesses. The water supply system consisting of two wells with a safe yield of 2,680,000 gallons per day along with a jockey pump and a backup electric generator, and a portion of the distribution system (now over 16,000 feet of water mains and services) have already been built. Such facilities have a

[1] Current schedules call for The Pinehills to be fully completed in 10 years.

cost of over $4,000,000. Because The Pinehills project is partly constructed and occupied, the water system is already in use. As construction progresses, there will be increasing use of the water system.

C. Requested Approvals

In this filing the Company primarily seeks approval of rates for water service, all as set forth in the proposed tariffs filed (Exhibit PWC-1) and as supported by the revenue requirements calculations of Mr. Alcott (Exhibit PWC-5), as well as Mr. Alcott's testimony (Exhibit PWC-4). As discussed in Sections II.A. and B. below, the Company's rate proposal seeks to allow the Company to collect rates that cover the costs of providing service, while keeping those charges to the most reasonable level possible. Exhibit PWC-4, pp. 12-13; Tr. 67, 68. Further, as a new water company with a new distribution system, the Company seeks approval as may be required by Massachusetts General Laws, Chapter 165, Section 1A with respect to adequacy of the water distribution system. Exhibit PWC-3 shows that the Company is in compliance with General Laws, Chapter 111.

Additionally, the Company has presented a significant amount of information about the facilities lease with an affiliate, Pine Springs Realty, LLC pursuant to which the Company leases (or will lease) a significant portion of the water supply and distribution system. *See e.g.*, Exhibits DTE 1-17, 1-18. The Company has also provided significant information about other arrangements with affiliates that will enhance the Company's ability to provide economical service. *See e.g.*, Exhibits PWC-2, pp. 10, 11, 13; Exhibits DTE 1-19, 1-21.

The Company had requested that, to the extent the Department deems necessary, the Department approve the Company's lease arrangement and/or any affiliate transactions. It is, however, the Company's belief that approval of neither is required. As explained in Exhibit DTE 2-5, the lease is an operating not a capital lease. Because of the factors discussed in that exhibit, the lease should not be considered a financing and should not require Department approval under G.L.c. 164 § 14, as incorporated into c. 165. With respect to affiliate transactions, the Company believes that no approval is required. G.L.c. 165 § 4A. Further, the Company believes because the only charges to it from affiliates will directly relate to water service such charges are reasonable and proper. Tr. 33, 39. In any event, the Company desires to be as forthright as possible to the Department regarding its affairs, so it has identified such transactions, filed contracts and provided relevant information. See Exhibit PWC-2. If the Department's approval of any particular transaction or relationship is required, the Company believes that the record shows the reasonableness thereof.[2]

II. THE COMPANY'S REVENUE REQUIREMENTS PROPOSAL

A. Description

As discussed above, the Company is a newly formed company and only just in the process of developing its water distribution system and its customer base. It has only served customers (on an interim rate basis) for the last few months. Such facts preclude ratesetting on the most common approach of calculating the total cost of service in a historic test year. Here there is no operating or financial history – yet service will be provided and customers using the service should pay an appropriate cost. *See* Order, dated August 13, 2001, p. 3.

[2] Should any such approval be required, the Company has requested approval thereof. Company Initial Filing letter dated April 13, 2001.

Therefore, relying upon precedent for other newly formed water companies (*see* Section II.C., below), the Company has developed rates using projected costs and projected customer numbers and revenues at buildout of the entire project. These estimates are very reasonable and have a solid basis. Already a substantial portion of the water supply and distribution system is in place, so the exact cost of that is known. The cost and amount of the remaining plant likewise can be known with reasonable engineering certainty. Exhibit PWC-4, WP-3. The Company's calculations allow for some potential slippage in how fast homes are sold (*i.e.*, growth in customer numbers).[3] Exhibit DTE 2-1. The calculations are further conservative with respect to rate base because of the Company's use of present value, rather than inflation-adjusted estimates. That fact alone provides a 13% range of conservatism. Exhibit DTE 2-2; Tr. 68. The other estimates that form the foundation for calculation of the Company's revenue requirement are also reasonable and measurable.

Customer numbers are known and conservative as discussed above. Customer usage levels are known because of the per residence occupancy limits established for The Pinehills community and because established industry averages for customer consumption levels are used. Exhibit DTE 2-12. Chemical costs and operations and maintenance costs all just use actual current unit costs multiplied by the pertinent usage levels. Exhibit DTE 2-15. Depreciation and local taxes are a function of plant costs – which as described above, are well known. Administrative costs are quite small and in no way unreasonable. Cost of money simply uses the Department formula for equity and a debt cost of 10%. The latter is

[3] Even if customer growth occurred at a rate faster than anticipated, that would not lower calculated charges because plant additions and additional costs would be correspondingly accelerated. Also, slower customer growth would not justify lower rates because revenues would be reduced accordingly.

reasonable because the Company is a start-up with the cost of borrowing funds best defined by the costs incurred by the parent company, a real estate development company. In addition to using these conservative inputs, the Company calculated the revenue requirements in the standard manner, as shown in Exhibit DTE 2-1. Also, an important input to the Company on the proper level of rates was its consideration of the charges of other Massachusetts companies with similarly new water systems. Exhibit PWC-4, p. 10.

Further, the Company filed proposed Rules and Regulations that cover the full range of Company-customer relations, including: application for service, connection, metering, billing and payment, termination, etc., as well as a variety of charges for services such as connection, testing, and other special services. As described in Section III, the basic quarterly service charge is specifically designed to be a significant source of the Company's collection of required revenues.[4] The other charges have been established to be consistent with similar charges of other Massachusetts water companies. Exhibit PWC-4, p. 10.

B. Rationale for the Company's Rate Proposal

As discussed above, two significant reasons for the form of the Company's proposal are that: (i) the Company has no operating history on which to base costs and (ii) development of the Company's full system and customer base will not occur for several years. Additionally, as discussed in Section II.C., below, in such circumstances in previous cases the Department has accepted proposals similar to that of the Company (*see e.g.*, *Pond Properties, Inc.*, D.P.U. 90-91 (1990); *Glacial Lake Charles Aquifer Water Co.*, D.P.U. 88-197 (1989)). Further, through this approach, the Company has the opportunity to cover its costs in the long run while imposing charges that are both in line with the rates of other Massachusetts water companies with substantially new systems and are fair to early customers. Record evidence shows that were the Company to use traditional ratemaking approaches, rates would be several times higher. Exhibit DTE 2-25; Exhibit PWC-4, WP-6. As Mr. Alcott described it:

> In order to normalize charges to customer over time, the proposed rates are based on full buildout, which assumes that the system is completely constructed and all of the planned customers are online. This approach assures that individual ratepayers are charged fair and reasonable rates, regardless of when they are connected to the system. The proposed lease payments, consisting of an annual base rent, deferral of charges when actual costs exceed actual net revenues and additional payments to reduce those deferrals, provide a mechanism for tracking actual costs and payments, which can be used in future rate cases for evaluating and adjusting rates and revenues.
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> Exhibit DTE 2-25.

See also Exhibit DTE 1-17.

C. Applicable Precedent

As noted above, the Department has endorsed an approach of determining rates for a start-up water company based on costs and revenues at buildout. *Pond Properties, Inc.*, D.P.U. 90-91 (1990). Also, the Company is incurring much of the costs for its water supply and distribution plant through a lease. The lease and the reasons to use a lease are described in more detail in Section IV. The Company does note that the Department has reviewed the lease arrangement for the Hingham water treatment plant and has allowed the costs incurred under that arrangement in water service rates. *Mass-American Water Company*, D.P.U. 95-118 (1995). Because of such precedent and the Department's decision giving a pre-approval to rate base additions in *Salisbury Water Company*, D.P.U. 91-122 (1992), the Company believes that

[4] 25% of General Metered Service Costs, and about 20% of Total Company revenue.

its proposal in this case is in line with prior approvals of the Department and likewise should be approved.

III. THE COMPANY'S RATE DESIGN PROPOSAL

The Company has proposed to collect its required revenues partially through the General Metered Service charges and partially through the Fire Protection Service charges. The division between the two services is based on the industry norm of Fire Protection charges generally amounting to about 20% of a water company's total charges. General Metered Service charges then were broken down between basic service charges and volumetric charges. Basic service charges are intended to cover the Company's costs of rendering the components of service that are unaffected by an individual customer's level of usage, *e.g.* costs of meter reading, billing customer accounting, and of the supply, distribution and meter plant. Exhibit PWC-4, Exhibit SBA-1, Sch. 3. Because these costs are incurred regardless of the level of usage and because this particular customer base is likely to have a significant seasonal component, the Company determined that basic service charges ought to collect 25% of the Company's total revenue requirements. That yields a monthly charge of $40. Incidentally, the resulting proposed volumetric charge of $8 charge per 1000 gallons is again in line with other similar companies in Massachusetts. Exhibit PWC-4, p. 10. The revenue requirements remaining to be recovered through the fire protection charges were allocated between public protection service (*i.e.*, the fire hydrants throughout The Pinehills) and private protection service, based upon the number of units to be used for each of the public and private services. With 311 of the projected 360 fire hydrants being "public" hydrants, the Company has allocated 86.39% of the costs of fire protection service to public fire protection. Exhibit PWC-4, SBA-1, Sch.3, p. 2. In summary, the Company has proposed a rate design that reasonably allocates costs to various services on the basis of cost causation and in a way that should best allow an opportunity for recovery of the costs.

IV. THE FACILITIES LEASE

The Company has entered into a lease with its affiliated company, Pine Springs Realty, LLC ("PS Realty"). This lease has a five year term and is renewable at a rent that would be negotiated at the time of renewal. Through the lease, the Company has the right to use about $12,000,000 of water supply and distribution facilities that currently exist or will be built over the next 10 years. As shown in Exhibit DTE 1-18, Attachment DTE 1-18, Schedule D, the rent is calculated in a manner consistent with the Department's standard cost of service calculations, but allows for a deferral of a portion of the charges so that customer rates could be maintained at a level deemed to be in the range of other comparable companies.

Record evidence shows that use of the lease here benefits customers for several reasons. *See e.g.*, Exhibit DTE 1-17. First, the lease allows tracking of utility costs by segregating plant used for utility service from that related to the real estate development activities of the Company's owners. Second, it helps achieve the Company's goal of spreading costs out over time to mitigate the impacts on customers, particularly those who are early customers and would otherwise have to pay much higher rates to support a water supply and distribution system designed to serve customers at full project buildout. Further, the lease helps the Company achieve lower costs overall because tax savings are thereby allocated to whichever of the Company or its affiliate is in the position to best use such savings. Theoretically, because at least some of the Company's financing will originate from its owners or other affiliates, the collective ability to reduce their costs through such tax planning will make possible lower capital costs.

For all these reasons, the Company submits that use of the lease for the supply and distribution plant is reasonable and appropriate. Again, to the extent some approval thereof is needed, the Company urges a grant of such approval.

V. DEVELOPMENT OF REVENUE REQUIREMENTS

As noted above, the Company has incurred certain levels of costs of plant installation and maintenance to date. However, because of the start-up nature of the Company at this time, such amounts are only partially representative of costs that will be incurred on an ongoing basis. Therefore, the Company has used costs and revenues projected as of full buildout of the project. One primary effect of this approach is to avoid subsidization of later customers by early customers. Exhibit DTE 1-17.

A. Rate Base and Depreciation

At least initially, the Company itself will only own contributed plant ($11,333,000 at buildout) and it will used leased facilities for supply and distribution functions (over time $12,172,000). Therefore, it takes no return or depreciation on rate base. Costs associated with such plant therefore will technically be imposed as lease charges upon the Company, and collected through rates accordingly. *See* Exhibit PWC-4, Exhibit SBA-3, Sch. 1. Because of the general flow-through calculation, the Company calculated depreciation and return on the plant at buildout less contributed plant. Exhibit PWC-4 at Exhibit SBA-6. Depreciation is calculated on the per account engineering analysis multiplied by accepted industry averages for depreciation rates. Exhibit PWC-4 at Exhibit SBA-2, Sch. 3.

B. Operations and Maintenance Costs

The Company has also estimated operations and maintenance costs. It used year 2000 expense levels where possible, but for various items, the Company had to make adjustments to ensure covering all costs. *See* Exhibit PWC-4 at Exhibit SBA-2, Sch. 1. As shown in Exhibit DTE 2-15, Attachment 2-15, there is a solid basis for such estimates. Similarly, known real property tax rates were applied to reasonably estimated plant costs to yield property tax cost. Exhibit PWC-4 at Exhibit SBA-2, Sch. 2. Using this approach the Company calculated total operations and maintenance expense to be recovered of $455,000 plus property taxes of $75,000.[5]

C. Cost of Capital

The Company's cost of capital is, like depreciation, flowed-through the lease. Using a composite return of 10.75%, determined to be reasonable given the circumstances of this company and with reference to the Department's standard form of equity cost calculation, the Company derived total capital costs of $1,827,000. These returns are reasonable as discussed in Section II.A., above.

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[5] Revision in DTE-RR-1 (rounded to $1,000s).

D. Total Revenue Requirements/Rates

Thus, the Company has determined the cost of providing service to its customers is $2,357,000 annually.[6] DTE-RR-1, Exhibit SBA-2(revised). The Company then calculated the total consumption by specific comparable usage levels for a major customer now constructing its hotel/conference center, and industry averages for other customers. Exhibits DTE 2-12, 2-13 and 2-14. These consumption levels were applied to fixed number of consumers that can be connected to the Company's system. Then, expected unit usage was divided into total cost to yield the unit cost and applied to rates.

VI. CONCLUSION

The Company has proposed rates based on known costs and conservative cost estimates and has taken several steps to mitigate the charges to customers and to avoid "generational" subsidization. The approach of using costs and revenues at buildout and basing significant plant conform to precedent and benefit customers. The Department should approve the Company's rates as proposed.

Respectfully submitted
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By Its Counsel

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[6] As described above, this level of cost is conservative for several reasons including exclusion of costs (a portion of rate case expenses (DTE-RR-3), certain meter reading and billing expense (DTE-RR-1) and use of current, uninflated costs for significant plant addition) that would otherwise be properly considered in setting the rates.

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Dated: September 14, 2001

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